Office Supreme Court, U. S.
FILED
NOV 15 1932
CHARLES ELMORE CROPLEY
CLERK

FILE COPY

No. 163

In the Supreme Court of the United States

OCTOBER TERM, 1932

ATLANTIC CITY ELECTRIC COMPANY, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statutes and regulations involved	2
Statement	2
Summary of Argument	5
Argument:	
I. The American Gas and Electric Company did not own directly or control substantially all of petitioner's stock	6
II. Petitioner, being a public service Corporation, must file separate returns for the year 1917	18
Conclusion	21
Appendix	22–25

CITATIONS

Cases:

Burnet v. *Bank of Italy*, 46 F. (2d) 629, certiorari denied, 283 U. S. 846 — 7

Burnet v. *J. Rogers Flannery & Co.*, 286 U. S. 524 — 17

Burnet v. *Peavy-Wilson Lumber Co.*, 286 U. S. 524 — 17

Carnie-Goudie Manufacturing Co., 18 B. T. A. 893 — 17

Commissioner v. *City Button Works*, 49 F. (2d) 705, certiorari denied, 284 U. S. 670 — 9

Commissioner v. *Shillito Realty Co.*, 39 F. (2d) 830 — 11

Denunzio, Jos., Fruit Co. v. *Commissioner*, 49 F. (2d) 41, certiorari denied, 284 U. S. 671 — 7

Duke Power Co. v. *Commissioner*, 44 F. (2d) 543, certiorari denied, 282 U. S. 903 — 14

Elko Lamoille Power Co. v. *Commissioner*, 50 F. (2d) 595 — 8

Finance & Investment Corporation v. *Burnet*, 57 F. (2d) 444 — 8

Good Mfg. Co. v. *Burnet*, 58 F. (2d) 685 — 7

Hamilton Carhartt Cotton Mills v. *Commissioner*, 56 F. (2d) 145 — 7

Hamlin v. *Toledo, St. L. & K. C. R. Co.*, 78 Fed. 664 — 8

Handy & Harman v. *Burnet*, 284 U. S. 136, reversed, 284 U. S. 583 — 7, 10, 12, 17

Howes Bros. Hide Co. v. *Commissioner*, 49 F. (2d) 878, reversed, 284 U. S. 583 — 10, 11, 18

Ice Service Co. v. *Commissioner*, 30 F. (2d) 230 — 9

Cases—Continued. Page

Koch & Co., Inc., Isse, Appeal of, 1 B. T. A. 624 ..... 9, 15
Lavenstein Corporation v. *Commissioner*, 25 F. (2d) 375 14
Madera Yosemite Big Tree Auto Co. v. *United States*, 49 F. (2d) 672 17
Montgomery Cotton Mills v. *United States*, 67 C. Cls. 169 6
Pelican Ice Co. v. *Commissioner*, 37 F. (2d) 285 14
Peavy-Wilson Lumber Co. v. *Commissioner*, 51 F. (2d) 165, reversed, 286 U. S. 524 15
Peytona Lumber Co. v. *Burnet*, 55 F. (2d) 27, certiorari denied, Oct. 10, 1932 17
Schlafly v. *United States*, 4 F. (2d) 195 9
Spencer v. *Smith*, 201 Fed. 647 8
Temtor Corn & Fruit Products Co., In re, 299 Fed. 326, affirmed *sub-nom. Schlafly* v. United States, 4 F. (2d) 195 14
Union Pacific Railroad Co. v. *Commissioner*, 17 B. T. A. 793 19
United States v. *Cleveland, P. & E. R. Co.*, 42 F. (2d) 413 ..... 7, 9, 11
United States v. *Whyel*, 19 F. (2d) 260 14
Wadhams & Co. v. *United States*, 67 C. Cls. 235 ..... 7, 17
Warren v. *King*, 108 U. S. 389 8

Statutes:

War Revenue Act of 1917, c. 63, 40 Stat. 300 13
Revenue Act of 1918, c. 18, 40 Stat. 1057, 1082, Sec. 240 23
Revenue Act of 1921, c. 136, Sec. 1331, 42 Stat. 227, 319 22
Revenue Act of 1924, c. 234, 43 Stat. 253, 288, Sec. 240 8
Revenue Act of 1926, c. 27, 44 Stat. 9, 46, Sec. 240 9
Revenue Act of 1928, c. 852, 45 Stat. 791, 831, Sec. 141 9
Revenue Act of 1932, c. 209, 47 Stat. 169, 213, Sec. 141 9

Miscellaneous:

Congressional Record, Vol. 57, Part 1, p. 549 14
H. Rep, No. 179, 68th Cong., 1st sess., p. 24 9
H. Rep. No. 350, 67th Cong., 1st sess., p. 16 14
S. Rep. No. 275, 67th Cong., 1st sess., p. 19, 20, 34 14
S. Rep. No. 617, 65th Cong., 3d sess., p. 18 14
Treasury Regulations 41:
Art. 77 13
Art. 78 13
Treasury Regulations 45:
Art. 631 23
Art. 633 24
Treasury Regulations 62, Art. 633 25

In the Supreme Court of the United States

OCTOBER TERM, 1932

No. 163

ATLANTIC CITY ELECTRIC COMPANY, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 19-25) is reported in 15 B. T. A. 1084. The opinion of the Circuit Court of Appeals (R. 34–38) is reported in 57 F. (2d) 186.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 11, 1932. (R. 38.) The petition for a writ of certiorari was filed June 17, 1932, and granted October 10, 1932. (R. 39.) Jurisdic-

tion is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

1. All of petitioner's common stock, constituting 77 per cent of its total outstanding stock, was owned directly by the American Gas and Electric Company. The balance of its stock, being preferred stock with voting rights and redeemable at any time, was owned by outside interests. Were petitioner and the American Gas and Electric Company affiliated corporations during the years 1917, 1918, and 1919, within the meaning of Section 240 (b)(1) of the Revenue Act of 1918, and Section 1331 (b)(1) of the Revenue Act of 1921?

2. Petitioner was a public service corporation operated independently from the American Gas and Electric Company and was neither physically connected nor merged with that company, nor had it received special permission to file consolidated returns. Was it entitled to affiliation for 1917 under the terms of Section 1331 of the Revenue Act of 1921?

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are set forth in the Appendix, pp. 22–25, *infra*.

STATEMENT

The findings of fact made by the Board of Tax Appeals (R. 15–19) may be summarized as follows:

During the taxable years 1917, 1918, and 1919, and for many years prior thereto, the American Gas and Electric Company was a holding corporation owning common stock in a number of lighting and power companies. (R. 16.) It had in excess of 3,000 stockholders. (R. 17.)

The petitioner is a public service corporation organized under the laws of New Jersey and engaged in the business of supplying light, heating, and power in and around Atlantic City, New Jersey. During the taxable years in question it had outstanding 12,500 shares of common stock of $100 par value each, all of which were owned by the American Gas and Electric Company, and 3,702 shares of preferred stock, none of which were owned by the American Gas and Electric Company, although from 655 to 761 of such shares were owned by stockholders of the American Gas and Electric Company.[1] The common stock owned by the American Gas and Electric Company constituted about 77 per cent of the total outstanding common and preferred stock of the petitioner. Holders of the preferred stock were entitled to vote and such stock

[1] The stockholders in the American Gas and Electric Company who owned some of the preferred stock in the petitioner must be taken as "outside interests." Obviously their holdings in the two corporations were not "in like proportions." The Board found (R. 17) that "the control and ownership exercised by the American Gas and Electric Company resulted from its absolute ownership of the entire common stock of its subsidiaries and not from control or ownership of preferred stock by its stockholders."

was preferred to the extent of an annual cumulative dividend of 6 per cent and on final liquidation. It was redeemable at any time and had no other interest in dividends above 6 per cent. (R. 16.)

In no instance during the years in question did any holder of preferred stock vote against or object to any action taken at any stockholders' or directors' meeting of the petitioner, nor against any proposition advanced by the American Gas and Electric Company or its representatives, but voted in conformity thereto. Dividends on the preferred stock at the rate in the contract amount of 6 per cent were always paid promptly and there have never been any unpaid cumulative dividends. (R. 17.)

All financial matters and operations of the petitioner were conducted by and carried on through the American Gas and Electric Company and the executive operations of the petitioner were carried on in the office of the American Gas and Electric Company at New York City. (R. 18.)

The respondent determined deficiencies against the petitioner for the taxable years in question on the basis of separate returns and refused to consolidate the returns of petitioner with those of the American Gas and Electric Company. (R. 15.) The Board of Tax Appeals held that the two corporations were affiliated and should file consolidated returns. The Commissioner appealed, and the Circuit Court of Appeals reversed the Board. (R. 38.)

SUMMARY OF ARGUMENT

I. The principal question here presented is whether the American Gas and Electric Company owned or controlled "substantially all the stock" of petitioner. It owned all the common stock, which was 77 per cent of the total outstanding stock. This was not "substantially all." The fact that the outstanding 23 per cent, owned by outside interests, was all preferred stock limited to 6 per cent cumulative dividends furnishes no reason for not considering such stock, since the statute refers to ownership or control of stock and makes no distinction between common and preferred stock. Moreover, the outstanding preferred stock had voting privileges and the Regulations of the Treasury Department (which have received legislative approval) and the cases hold that the statute refers to *voting* stock, whether preferred or common. Nor did the right to redeem the preferred stock give *control* over that stock prior to the exercise of the right. A "control of stock without title, beneficial enjoyment or other legal means to enforce it" and resting only upon acquiescence, business necessities, or other consideration of no binding force is not sufficient to meet the requirements of the statute.

II. Section 1331 (b) of the 1921 Act, affecting the tax involved for 1917, provides that public service corporations which (1) were operated independently, (2) were not physically connected or

merged, and (3) did not receive special permission to make a consolidated return, shall not be entitled to affiliation. Petitioner does not come within this additional proviso of the statute and for this additional reason should be denied affiliation for 1917.

ARGUMENT

I

THE AMERICAN GAS AND ELECTRIC COMPANY DID NOT OWN OR CONTROL SUBSTANTIALLY ALL OF PETITIONER'S STOCK

Section 1331 (b) of the Revenue Act of 1921 (*infra*, p. 22), and Section 240 (b) of the Revenue Act of 1918 (*infra*, p. 23) both provide that before two or more corporations are entitled to affiliation it must appear either (1) that one corporation "owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others," or (2) that "substantially all the stock of two or more corporations is owned or controlled by the same interests." [2]

It is conceded that this case does not involve the second of the above provisions of the statute relat-

[2] The quotations are taken from Section 240 (b) of the Revenue Act of 1918. Section 1331 (b) of the Revenue Act of 1921 (*infra*, p. 22), made applicable to the year 1917, is substantially the same except that subdivision (2) does not contain the word "controlled" and the proviso clause placed certain additional limitations upon affiliation. See *Montgomery Cotton Mills* v. *United States*, 67 C. Cls. 169, 171. This difference in the Acts as affecting the year 1917 will be discussed later, pp. 18–21, *infra*.

ing to ownership or control *by the same interests.* (Pet. 8.) The sole question is whether the American Gas and Electric Company owned directly or controlled substantially all of petitioner's stock.

The American Gas and Electric Company owned directly all of petitioner's common stock, which was only 77 per cent of its total outstanding stock. This was not "substantially all" within the meaning of the statute. In *Handy & Harman* v. *Burnet,* 284 U. S. 136, it was held that 76.66 per cent did not constitute "substantially all" and it has been held that 88 per cent (*Good Mfg. Co.* v. *Burnet,* 58 F. (2d) 685 (App. D. C.)), 85 per cent (*Burnet* v. *Bank of Italy,* 46 F. (2d) 629, 630 (C. C. A. 9th)), certiorari denied, 283 U. S. 846, 77 per cent to 84 per cent (*United States* v. *Cleveland, P. & E. R. Co.,* 42 F. (2d) 413 (C. C. A. 6th)), 83⅓ per cent (*Jos. Denunzio Fruit Co.* v. *Commissioner,* 49 F. (2d) 41 (C. C. A. 6th)), certiorari denied, 284 U. S. 671, and 80 per cent (*Wadhams & Co.* v. *United States,* 67 C. Cls. 235; *Hamilton Carhartt Cotton Mills* v. *Commissioner,* 56 F. (2d) 145 (C. C. A. 5th)), did not constitute "substantially all" of the stock of a corporation.

But the petitioner contends that the American Gas and Electric Company owned all the stock of the petitioner because it owned all the *common* stock of that company, and that the outstanding stock not owned by the American Gas and Electric Company should not be considered since it was all *preferred* stock with no interest in the earnings

above annual dividends of 6 per cent. It is said that because of their limited interest in the corporation the preferred stockholders are more nearly creditors than stockholders. But it is well settled that preferred stockholders are not creditors, but on the contrary are, as the name signifies, owners of corporate capital stock. *Warren* v. *King,* 108 U. S. 389, 398; *Finance & Investment Corporation* v. *Burnet,* 57 F. (2d) 444 (App. D. C.); *Elko Lamoille Power Co.* v. *Commissioner,* 50 F. (2d) 595 (C. C. A. 9th); *Hamlin* v. *Toledo, St. L. & K. C. R. Co.,* 78 Fed. 664 (C. C. A. 6th); *Spencer* v. *Smith,* 201 Fed. 647 (C. C. A. 8th). The statutes here involved refer to ownership or control of *stock* and make no distinction between preferred stock and common stock and if that term is given its ordinary meaning it must be taken to include preferred stock as well as common. Particularly is this true where, as here, the preferred stock has voting privileges (R. 16), showing further that the owners of such stock are not mere creditors, but that as shareholders they own proprietary interests in the business and by their votes may participate in its management.

The applicable regulations of the Treasury Department (Article 633, Regulations 45 and 62; pp. 23–24, *infra*) have construed the statutes as referring not alone to common stock, but to all *voting* stock, whether common or preferred.[3] This inter-

[3] The reason for this interpretation will be discussed later; see pp. 15–16, *infra.*

pretation has received legislative approval in Section 240 (c)(1) of the Revenue Act of 1924, c. 234, 43 Stat. 253, 288 (U. S. C., Title 26, Sec. 993), which section, in reenacting the statutes here involved, provides that two corporations are deemed affiliated "if one corporation owns at least 95 per centum of the *voting* stock of the other, * * *." (Italics ours.) The Report of the Committee on Ways and Means, referring to this provision, states (House Report No. 179, 68th Cong., 1st Sess., p. 24.)

> The requirement that the stock held must be "voting" stock merely embodies in the law the present rule of the Treasury Department.

See also Section 240 (c) and (d) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 46 (U. S. C. App., Title 26, Sec. 993), Section 141 (d) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 831 (U. S. C. Sup. V, Title 26, Sec. 2141), and Section 141 (d) of the Revenue Act of 1932, c 209, 47 Stat. 169, 213. The regulations, having been approved by later clarifying Acts of the legislature and having stood unchanged for many years, have the force and effect of law.

Moreover, the cases hold that the earlier Acts related to *voting* stock. *Schlafly* v. *United States,* 4 F. (2d) 195, 200 (C. C. A. 8th); *Ice Service Co.* v. *Commissioner,* 30 F. (2d) 230 (C. C. A. 2d); *United States* v. *Cleveland, P. & E. R. Co.,* 42 F. (2d) 413 (C. C. A. 6th), *supra;* cf. *Commissioner* v. *City Button Works,* 49 F. (2d) 705 (C. C. A.

2d), certiorari denied, 284 U. S. 670. See also *Appeal of Isse Koch & Co., Inc.*, 1 B. T. A. 624.

In *Howes Bros. Hide Co.* v. *Commissioner*, 49 F. (2d) 878 (C. C. A. 1st), the court held that where the same interests owned directly all the common stock of two corporations, affiliation could not be denied merely because outside interests owned a substantial block of voting preferred stock in one of the corporations. But that decision was reversed by this Court *per curiam* (284 U. S. 583) on the authority of its decision in the *Handy & Harman case*, 284 U. S. 136, *supra*.

The petitioner contends that the reversal by this Court in the *Howes Bros. Hide case* was because the same interests did not hold the stock of the corporations there involved in like proportions—a requisite which is established by the *Handy & Harman* decision, *supra*. It is true that the facts in the *Howes Bros. Hide case* do show that the same interests did not hold the shares of the corporations involved in like proportions, but that point was not discussed by the Circuit Court of Appeals in its opinion nor was it raised in the Government's petition for certiorari. In the *Howes Bros. Hide case*, as said by the Circuit Court of Appeals (49 F. (2d) 878, 880), "The main question is as to the minority holding of first preferred stock in the Howes brothers corporation," and the decision was based on that point. The Government's petition for certiorari dealt chiefly with that question as did likewise the brief in opposition. While the de-

cision in the *Handy & Harman case* did not involve the precise question raised in the *Howes Bros. Hide case* or in this case, we are unwilling to assume, as urged by petitioner, that this Court reversed the *Howes Bros. Hide case* on a point not passed upon by the Circuit Court of Appeals and not raised in the petition for certiorari.

In deciding the questions presented in the *Howes Bros. Hide case* it was pertinent to refer to the *Handy & Harman case,* because it was there held that ownership and control meant *stock* ownership and control, and not ownership or control of the business. It was also decided that control must be a legally enforceable control, as distinguished from any other kind of control. Consequently, we believe that the questions presented in the *Howes Bros. Hide case,* and again presented in this case, have already been determined by this Court.

The only other decision holding that voting preferred stock should not be taken into account in determining the application of the statutory provisions here involved is *Commissioner* v. *Shillito Realty Co.,* 39 F. (2d) 830 (C. C. A. 6th). But, as pointed out in the later decision by the same court in *United States* v. *Cleveland, P. & E. R. Co.,* 42 F. (2d) 413, 419 (C. C. A. 6th), *supra,* that case went off on its own peculiar facts and seems to have turned on the fact that outstanding voting power was controlled by proxies, a fact not presented here. The latter case is in conformity with the decision below and should be taken as modifying, if not

actually overruling, the decision in the *Shillito case*. In any event the *Shillito case* was decided prior to this Court's decision in the *Howes Bros. Hide case, supra,* which, as stated above, apparently disposes of the question.

We submit that the court below correctly held that the American Gas and Electric Company did not own substantially all of petitioner's "stock" within the meaning of the statute as interpreted by the courts and the regulations.

Petitioner's principal argument goes to the intent and purpose of the affiliation statutes. It is contended that since the purpose of the statute, as stated in the *Handy & Harman case, supra,* (p. 140), was "to secure substantial equality as between shareholders who ultimately bear the burden" the statute can not apply to the preferred stockholders here because the burden of intercompany transactions and of the Federal income taxes rests upon the common stockholders alone. There are two answers to this contention. First, the preferred stockholders may bear their share of the burden. It was the purpose of the statute, as the *Handy & Harman case* discloses, to protect a substantial minority who might ultimately bear the burden of another's taxes. Affiliation was required where the same stockholders owned all except a negligible minority of the stock in the common enterprise, in which event no substantial inequality

resulted from consolidation. But where the outstanding minority was substantial, affiliation was not required. Here the preferred stockholdings were substantial and uncontrolled and potentially bore their share of the burden. If the American Gas and Electric Company had decided to throw upon this petitioner the whole burden of paying the consolidated tax levied on its 30 or 40 subsidiaries (R. 17) or even make this petitioner pay part of the excess profits taxes on income earned by these other subsidiaries, it seems evident that the minority preferred stockholders would bear a distinct burden. Such payment might not only serve to rob such stockholders of their immediate right to dividends, but might impair their capital investment as well. The fact that dividends were actually paid in the years involved does not mean that the potential burden referred to did not exist. Petitioner's argument would make affiliation depend upon the varying successes or failures of the corporation rather than upon the statute making stock ownership or control the test.

There is another reason why petitioner's contention is unsound. It was not the sole purpose of affiliation to secure equality among shareholders. That was one purpose but the primary purpose was to prevent tax evasion of the excess-profits taxes levied under the War Revenue Act of 1917, c. 63, 40 Stat. 300, and the Revenue Act of 1918, c. 18, 40 Stat. 1057. That intent is shown from the legis-

lative history of the Act in question [4] and by regulations of the Treasury Department promulgated contemporaneously therewith (Regulations 45, Article 631). The courts have recognized this twofold purpose and have repeatedly held that the primary purpose was to stop tax evasion. *Duke Power Co.* v. *Commissioner,* 44 F. (2d) 543 (C. C. A. 4th), certiorari denied, 282 U. S. 903; *In re Temtor Corn*

[4] Provision for affiliation first appeared in the form of regulations (Articles 77 and 78, Regulations 41) promulgated by the Commissioner under the Revenue Act of 1917, c. 63, 40 Stat. 300. When the revenue bill of 1921 was under consideration the validity of those regulations as affecting 1917 taxes was questioned and for that reason Section 1331 of the Revenue Act of 1921, c. 136, 42 Stat. 227, 319 (*infra*, p. 22), was adopted providing for retroactive validation. See House Report No. 350, 67th Cong., 1st sess., p. 16; Senate Report No. 275, 67th Cong., 1st sess., p. 34.

The excess-profits taxes were continued in the 1918 Revenue Act and that Act provided for affiliation in language practically identical with that of the earlier regulations (Section 240, Revenue Act of 1918, c. 18, 40 Stat. 1057 (*infra*, p. 23)). While the principal purpose of the Act, like that of the earlier regulations, was to prevent tax evasion, a year's experience had revealed that affiliation also benefited the taxpayers. Congress clearly had in mind these two purposes. See Senate Report No. 617, 65th Cong., 3rd sess., pp. 8–9. See also Congressional Record, Vol. 57, Part 1, p. 549. Since the primary purpose was to prevent tax evasion, the filing of consolidated returns was made compulsory. It was not until the excess-profits tax was repealed with the passage of the Revenue Act of 1921, c. 136, 42 Stat. 227, that taxpayers were given the choice of filing separate or consolidated returns. See Senate Report No. 275, 67th Cong., 1st sess., pp. 19–20. *Duke Power Co.* v. *Commissioner*, 44 F. (2d) 543 (C. C. A. 4th), certiorari denied, 282 U. S. 903.

& Fruit Products Co., 299 Fed. 326, 331 (E. D. Mo.), affirmed *sub nom. Schlafly* v. *United States*, 4 F. (2d) 195, 200 (C. C. A. 8th); *United States* v. *Whyel*, 19 F. (2d) 260, 262 (W. D. Pa.); *Pelican Ice Co., Ltd.* v. *Commissioner*, 37 F. (2d) 285, 286 (C. C. A. 5th); *Lavenstein Corporation* v. *Commissioner*, 25 F. (2d) 375, 376 (C. C. A. 4th); *Peavy-Wilson Lumber Co.* v. *Commissioner*, 51 F. (2d) 163, 167 (C. C. A. 5th), reversed without opinion and apparently on another point, 286 U. S. 524. See also *Appeal of Isse Koch & Co., Inc.*, 1 B. T. A. 624.

In the light of this primary purpose to prevent tax evasion, it seems clear that the preferred stockholders must be considered. Congress evidently had in mind that an outstanding substantial minority interest would, as a practical matter prevent the transfer of profits from one company to another for the purpose of evading taxes. It was probably realized that manipulation jeopardizing the interest of the minority would not be attempted and if attempted would be enjoined in equity. Consequently where the adverse interest was substantial affiliation was not required. It was only when the outstanding interests were negligible that affiliation was deemed necessary. Certainly, in this case if the American Gas and Electric Company, for purposes of its own, had decided through price fixing, charges for services, or other means to deprive the petitioner of its income and to as-

sign this income arbitrarily to another of its less prosperous subsidiaries, it seems evident that the preferred stockholders, although in a minority, would have objected strenuously to such manipulation and could and would have effectively blocked such attempts.

Since this check by the substantial minority might not, in many cases, be effective unless that minority had voting power and a voice in the management, the Treasury Department has construed the statute as referring only to *voting* stock. As pointed out above, this interpretation has been sanctioned by the courts and has received legislative approval in subsequent Acts and should be given the force and effect of law. If it be said that the Treasury Department was wrong in so interpreting the statute, the word "stock" must then be given its general meaning and be taken to include all preferred stock as well as common stock.

We submit that considering the twofold purpose of the 1918 Act the preferred-stock holdings here involved must be considered; and since they must be considered, it follows that the American Gas and Electric Company did not own substantially all of petitioner's stock.

Since the American Gas and Electric Company did not own directly substantially all of petitioner's stock there remains the question of whether it controlled any stock it did not own. Petitioner contends that even if preferred stock must be taken into account the right of the American Gas and

Electric Company to redeem the preferred stock of the petitioner at any time gave that company *control* over the preferred stock. But a "control of stock without title, beneficial ownership, or other legal means to enforce it" and resting only upon acquiescence, business necessities, or other considerations of no binding force is not sufficient to meet the requirements of the statute. *Handy & Harman* v. *Burnet,* 284 U. S. 136, *supra; Burnet* v. *J. Rogers Flannery & Co.,* 286 U. S. 524; *Burnet* v. *Peavy-Wilson Lumber Co.,* 286 U. S. 524. As pointed out by the court below, the right of the American Gas and Electric Company to redeem did not confer upon that company any legally enforceable control prior to the exercise of that right. The right to redeem is somewhat analogous to an option to buy or an agreement to first offer stock to the majority stockholders. Such rights, without more, are not sufficient to constitute control of the stock within the meaning of the statutes prior to the exercise of the option or right. *Peytona Lumber Co.* v. *Burnet,* 55 F. (2d) 27 (C. C. A. 4th), certiorari denied, October 10, 1932, No. 133, October Term, 1932; *Wadhams & Co.* v. *United States,* 67 C. Cls. 235; *Madera Yosemite Big Tree Auto Co.* v. *United States,* 49 F. (2d) 672, 678 (C. Cls.); *Carnie-Goudie Manufacturing Co.,* 18 B. T. A. 893. Moreover, it does not appear from the findings of the Board of Tax Appeals that the American Gas and Electric Company was in a position during the

years in question to redeem the outstanding preferred stock.

In the *Howes Bros. Hide case, supra,* the outstanding preferred stock was subject to redemption after 90 days' notice. If, in reversing the decision of the Circuit Court of Appeals for the First Circuit in that case, this Court intended to pass upon the question of *control* arising out of the right to redeem the preferred stock, it has disposed of this contention of the petitioner.

We submit that the American Gas and Electric Company did not own or control substantially all of petitioner's stock as required by the statutes.

II

PETITIONER, BEING A PUBLIC SERVICE CORPORATION, MUST FILE SEPARATE RETURNS FOR THE YEAR 1917

There are two statutes involved in this case, Section 240 of the Revenue Act of 1918 (*infra* p. 23) and Section 1331 of the Revenue Act of 1921 (*infra,* p. 22) which retroactively amended the Revenue Act of 1917. The first of these statutes applies to the 1918 and 1919 taxes in this case and the second applies only to the 1917 tax. The foregoing argument applies equally to all three years since the provisions of both statutes pertinent to the discussion are identical. However, Section 1331 contains a proviso which, we submit, furnishes an additional reason for denying petitioner the right to affiliation for the year 1917. Section 1331, *infra,* provides:

> For the purposes of this section, public service corporations which (1) were operated independently, (2) were not physically connected or merged, and (3) did not receive special permission to make a consolidated return shall not be construed to have been affiliated; * * *[5]

It is manifest from the record that petitioner was a public-service corporation (R. 16), operated independently as a separate and distinct corporation from the American Gas and Electric Company, with which it seeks to affiliate. It was organized and operated in a different State under a different State law. (R. 16.) Each had its own corporate existence with its own corporate structure, separate and apart from each other.

Not only was the petitioner operated independently as a distinct entity, but from the record it was not physically connected with the American Gas and Electric Company. That company was a New York corporation with offices in New York City (R. 10), while the Atlantic City Electric Company was a New Jersey corporation operating in and around Atlantic City, New Jersey (R. 16).

Moreover, from the whole record it is clear that the petitioner here had not actually merged with the American Gas and Electric Company. That

[5] This provision was prompted by the improbility of tax evasion by public utilities through manipulation of accounts, due to their regulation by public service commissions. See *Union Pacific Railroad Co.* v. *Commissioner*, 17 B. T. A. 793.

company was a holding company. (R. 16–17.) There was no merger.

Furthermore, petitioner never received special permission to make consolidated returns as required by the statute. The very fact that the deficiency in these cases arises out of the refusal on the part of the Commissioner to permit affiliation and the fact that the deficiency is determined on the basis of a separate return (R. 15) shows that this requirement of the statute has not been met.

Since petitioner was operated independently from the holding company and since it was neither physically connected nor merged with that company, and since special permission could not have been obtained to file consolidated returns, it follows that petitioner is not entitled to affiliation for 1917.

It may be argued that the proviso referred to applies only to cases where two or more public service corporations seek affiliation with each other and does not apply where a public service corporation seeks affiliation with a holding corporation. But the record shows that in this same case the Scranton Electric Company, another public service corporation, is likewise seeking affiliation with the American Gas and Electric Company. (R. 15.)[6] To per-

[6] The *Scranton case* and this case were tried together before the Board on one record. In the Circuit Court of Appeals it was stipulated that only the record in this case should be printed and that the decision here should control the *Scranton case*. The time for filing a petition for certiorari in the *Scranton case* has been extended to December 11, 1932.

mit the two public service corporations to affiliate with one holding company and thereby become affiliated with each other would be permitting by indirection that which the statute directly prohibits.

We submit, for this additional reason, the petitioner must file separate returns for the year 1917.

CONCLUSION

The decision of the court below should be affirmed.

Respectfully submitted,

THOMAS D. THACHER,
Solicitor General.
G. A. YOUNGQUIST,
CHARLES B. RUGG,
Assistant Attorneys General.
SEWALL KEY,
J. P. JACKSON,
Special Assistants to the Attorney General.
ERWIN N. GRISWOLD,
Attorney.

NOVEMBER, 1932.

APPENDIX

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1921, c. 136, 42 Stat. 227, 319 (U. S. C., Title 26, Sec. 1067):

> SEC. 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.
>
> (b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided,* That such corporations or partnerships were engaged in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital. For the purposes

of this section, public service corporations which (1) were operated independently, (2) were not physically connected or merged and (3) did not receive special permission to make a consolidated return, shall not be construed to have been affiliated; but a railroad or other public utility which was owned by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations which were required to file a consolidated, return shall be construed to have been affiliated.

(c) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917.

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1082:

SEC. 240. (b) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

Treasury Regulations 45, issued under the Revenue Act of 1918, provide:

ART. 631. *Affiliated corporations.*—The provision of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation. Where one corporation owns the capital stock of another corporation or other corporations, or where the stock of two or more corporations is

owned by the same interests, a situation results which is closely analogous to that of a business maintaining one or more branch establishments. In the latter case, because of the direct ownership of the property, the invested capital and net income of the branch form a part of the invested capital and net income of the entire organization. Where such branches or units of a business are owned and controlled through the medium of separate corporations, it is necessary to require a consolidated return in order that the invested capital and net income of the entire group may be accurately determined. Otherwise opportunity would be afforded for the evasion of taxation by the shifting of income through price fixing, charges for services and other means by which income could be arbitrarily assigned to one or another unit of the group. In other cases without a consolidated return excessive taxation might be imposed as a result of purely artificial conditions existing between corporations within a controlled group. See articles 785, 791, 802, and 864–869.

ART. 633. *When corporations are affiliated.*—Corporations will be deemed to be affiliated (a) when one domestic corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (b) when substantially all the stock of two or more domestic corporations is owned or controlled by the same interests. The words "substantially all the stock" can not be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case. The owning or controlling of 95 per cent or more of

the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. Consolidated returns may, however, be required even though the stock ownership is less than 95 per cent. When the stock ownership or control is less than 95 per cent, but in excess of 50 per cent, a full disclosure of affiliations should be made, showing all pertinent facts, including the stock owned or controlled in each subsidiary or affiliated corporation and the percentage of such stock owned or controlled to the total stock outstanding. Such statement should preferably be made in advance of filing the return, with a request for instructions as to whether a consolidated return should be made. In any event such a statement should be filed as a part of the return. The words "the same interests" shall be deemed to mean the same individual or partnership or the same individuals or partnerships, but when the stock of two or more corporations is owned or controlled by two or more individuals or by two or more partnerships a consolidated return is not required unless the percentage of stock held by each individual or each partnership is substantially the same in each of the affiliated corporations.

Article 633 of Treasury Regulations 62, issued under the Revenue Act of 1921, is substantially the same as Article 633 of Treasury Regulations 45.

U. S. GOVERNMENT PRINTING OFFICE: 1932